Queen's Economics Department Working Paper No. 46

WORKING PAPERS FOR THE INDIV PROJECT

Philip Hardwick
Queen's University

Department of Economics
Queen's University
94 University Avenue
Kingston, Ontario, Canada
K7L 3N6

7-1970

WORKING PAPERS FOR THE INDIV PROJECT

(A) PHILIP HARDWICK

Discussion Paper No. 46

CONTENTS

These three background papers were prepared during the summer months of 1970 for a project which received financial support from the Institute of Economic Research.

J.C.R.R.

CORPORATE TAXATION IN POST-WAR CANADA

A Working Paper for:

THE INDIV PROJECT

under the direction of

J. C. R. Rowley

May, 1970

Philip Hardwick

There have been four main types of corporate taxation in post-war Canada. First, the excess profits tax which was primarily a war tax, and was abandoned in 1947; secondly, and most important, the federal corporation income tax; thirdly, the provincial corporation income taxes; and finally, certain other provincial taxes. Apart from changes in the rates of these taxes, several changes in the tax allowance for depreciation have also been made since the war. It is the purpose of this working paper to describe both these taxes and the changes in their rates.

EXCESS PROFITS TAX

This was aimed at recapturing for the state all profits derived by businesses from a level of activity regarded as directly attributable to the war. It taxed those profits which were in excess of some "normal standard" of profit for a business. Two methods could be used to determine the tax base: first, compare war-time and peace-time profits, and tax those war-time profits which are in excess of peace-time profits; and secondly, let the return on the capital employed in the business be the "standard", and tax all profits which are in excess of this.

1940-45. The "standard" used was based on pre-war earnings from 1936-9 experience. The rate in 1940 was 75% of excess profits, or 12% of total profits which, together with the corporation tax of 18%, made a minimum total tax rate of 30%. In 1941, the minimum rate was increased to 22%, raising the minimum total tax rate to 40% (the alternative rate remaining at 75% of excess profits). For 1942-5 the minimum rate under the excess profits tax was reduced back to 12%, but, in addition, the greater of a tax of 10% on total profits or 100% on excess profits was made payable. Where the 100% rate was paid, 20% of profits in excess of

116 2/3 % of "standard" profits was refundable after the war. Thus, if current profits were less than 116 2/3% of "standard" profits the total tax rate was 40% on total profit (including the 18% corporation tax); if current profits were greater than 116 2/3 of "standard profits, the tax was 30% of standard profits, plus 100% of excess profits. This meant that no company could retain during the war after mid-1942 more than 60% of its "standard" profits. Exemption from this heavy tax included most professional business, e.g. lawyers, teachers, doctors; and those performing personal services.

1946-7. The Minister of Finance justified the retention of the excess profits tax for two years after the war on the grounds that business conditions were still "abnormal", and only when "we could rely upon the forces of competition and bargaining to keep profits at normal levels" could the tax be repealed. The first relaxation of the tax was made for the fiscal years ending after December 31, 1945. Standard profits of less than $25,000 were increased by the addition of half the difference between the actual standard and $25,000. At the same time the rates became 22% on total profits (i.e., a minimum total rate of 40% when the 18% corporation tax is included), and, in addition, 20% of profits in excess of 116 2/3% of "standard" profits. So the rate was 40% up to 116 2/3% of "standard profits", and 60% on profits over that mark, with no refunds. For 1947, the corporation tax rate was increased to 30% from 18%, and the excess profits tax was limited only to those profits in excess of 116 2/3% of "standard" profits and reduced to 15%. Thus, profits up to 116 2/3% bore a total tax rate of 30%, and those over 116 2/3% bore a rate of 45%. The excess profits tax was completely repealed at the end of 1947.

Even after its repeal, a Board of Referees spent two years considering appeals on standard profit. These arose because greater discretion was given for the adjustment of standard profit in cases of hardship, and for new businesses -- in all, 8000 appeals were considered by this Board. It was finally disbanded in 1949.

FEDERAL CORPORATION INCOME TAX (See Tables 1 and 2)

All limited companies are subject to corporation income tax. Sole proprietorships and partnerships pay taxes on their profit at personal tax rates; and certain special rates of taxation are imposed upon certain types of companies, such as investment companies, non-resident-owned investment corporations, foreign business corporations and personal corporations -- these special rates will not be outlined here.[1]

At the end of the war, the federal corporation income tax was a straight-line rate of 18%. In 1947 it was raised to 30%, but, considered in the light of the elimination of the minimum rate of excess profits tax in the same year, the overall effect was to reduce the aggregate minimum rate from 40% to 30%. In 1949, a two-stage graduation scheme was adopted, and this is still in use today. Under this scheme, a rate of 10% was payable on incomes less than $10,000, and this was combined with a rate of 33% on profits over that amount. This system clearly discriminates against companies with large income, and its adoption was intended to benefit small businesses. In September, 1950, as part of the defence programme, the 10% rate was raised to 15%, and the 33% rate was

---

1. See Gilmour: Income Tax Handbook, Vols. I-II, 1968.

raised to 38%. On January 1, 1951, a 20% surtax was imposed on the higher rate, giving a combination of 15% on the first $10,000 and 45.6% on the excess; further, the right to file consolidated returns on payment of a rate usually 1% or 2% higher than the standard rate was withdrawn in respect of fiscal years ending after De-ember 31, 1951. On January 1, 1952, both rates were increased by a further 2% for financing of old age pensions under the provisions of the Old Age Security Act. Furthermore, in 1952, the 5% provincial corporation taxes of the "agreeing" provinces were repealed and substantially absorbed into the federal rate; thus, after rounding off the larger rate, the federal rates for 1952 were finally set at 22% on the first $10,000 and 52% on the excess (including the Old Age Security Tax which remained at 2% until the end of 1958, and was then raised to 3% for 1959 and subsequent years). For 1953 the rates were reduced to 20% on the first $20,000 and 49% on the excess. No changes were made in the corporation tax rates in 1954; by this time it had become one of the largest sources of federal tax revenue accounting for over a quarter of total revenue.

In 1955, the upper rate was reduced to 47%, but there were then no further changes in the corporation tax until 1958 when the bracket of income subject to the lower tax rate was increased by $5,000, from $20,000 to $25,000; but still the tax rates remained unchanged at 20% below $25,000, and 47% above that amount. In 1959 the Old Age Security Tax was raised to 3%, and the upper rate was increased by a further 2%, so that the rates became 21% on the first $25,000 of income, and 50% on the excess; there were no changes from these rates in 1960. In 1961 the bracket of income subject only to the lower tax rate was raised to $35,000.

The 1961 amending act provided for a 9% deduction from federal tax payable by corporations in accordance with the new arrangements with all those provinces which levied their own corporation taxes from 1962. Prior to 1952 there was no tax abatement allowed whatever; in 1952 a 5% abatement was allowed, but this was only relevant in Quebec where a 7% provincial corporation tax rate was payable; in the period 1953-6, the abatement was raised to 7% but was still only relevant in Quebec; in the period 1957-61, the abatement was raised to 9%, and became relevant in Ontario (where the provincial corporation tax rate was 11%) and Quebec (where the rate was 9% for 1957-9, 10% in 1960 and 12% in 1961) -- for the years 1960-1 (and up to 1966), Quebec received an additional 1% abatement in lieu of university grants; finally, in 1962, all provinces entered the corporation tax field, and the 9% abatement was allowed throughout the nation (with the exception of the North-West Territories and Yukon where the full federal rates still applied). A further 1961 measure was the imposition of a 13% tax on the profits of non-resident corporations carrying on business in Canada: this tax was raised to 15% in 1962.

From 1962 to 1966 the federal tax rate remained unchanged at 21% on the first $35,000 and 50% on the excess, with the 9% abatement allowed. In 1966, a 5% refundable tax was imposed on corporations and trusts with "cash profits" over $30,000 in respect of the taxation year included in whole or in part in the 18 month period commencing May 1, 1966 and ending October 31, 1961: this was to be refunded after a period of not less than 18 months and not more than 36 months from the original due date; interest was payable at 5% per annum. The tax base was "cash profits" less $30,000; "cash profits" were defined as the aggregate of taxable income for the year, depletion allowance, capital cost allowance

up to 50% of gross revenue, and deductible business losses of previous years, plus a few other minor factors. Although the tax was originally intended to apply until October 31, 1967, it was in fact terminated after only 11 months at the end of March 1967. Refunding commenced on June 30, 1968; payment was on a bi-monthly basis and for most taxpayers should have been completed early in 1970.

In 1967 the allowable abatement was raised to 10% for all provinces except the Yukon and North-West Territories, and in 1968-70 corporations became subject to a temporary surtax of 3% which had the effect of raising the federal corporation tax rates to 21.54% on the first $35,000 of income, and 51.41% on the excess (including the Old Age Security Tax of 3%).

A loop-hole which exists in the two-stage tax scheme is that an integrated large firm may split up into two or more corporations, each entitled to the lower stage tax rate only. In general, however, only one company of a group of "related" companies has been allowed the lower rate, and this "relationship" is based on a common ownership of shares. For purposes of this tax law, one corporation is said to be "related" to another if one of the following conditions is satisfied: (a) one corporation is controlled by the other; (b) both corporations are controlled by the same person or group of persons; (c) the two corporations are controlled by two persons who are related to each other, and one of whom owns one or more shares of both corporations. Corporations may be deemed related if the Minister of National Revenue is satisfied that the separate existence of the corporations in a tax year is not solely for the purpose of carrying out the business of those corporations

in the most effective manner, and one of the main reasons for such separate existence in the year is to reduce the amount of taxes which would otherwise be payable.

A further problem has arisen with regard to Co-operatives, Mutuals, and other similar organizations which enjoyed a considerable advantage during the war, and were able to accumulate reserves and expand activities when other private companies were restricted by heavy taxation. In 1945, a Royal Commission on Co-operatives was appointed to consider the problem. It recommended that the tax exemption granted to co-operatives be repealed, and that patronage dividends paid to members be deductible in calculating that income to which the tax was to apply. The present law provides that each new co-operative gets a three-year tax holiday when it is formed, and that all distributed patronage dividends are deductible from income (as recommended in the 1945 Commission). However, a comparison of the shareholding structures of ordinary corporations and co-operatives shows that these two factors give co-operatives a considerable advantage. The Carter Commission recommended that the three-year tax holiday be eliminated, that a 15% withholding tax on all patronage dividends be imposed, that patronage dividends should be deductible only to the extent that at least one-half be paid unconditionally in cash, and that any remaining income be taxed at the upper corporation tax rate. The 1969 White Paper, however, did not go this far: it withdrew the tax holding and suggested that the interest that co-operatives must be deemed to earn and pay tax on, based on its capital employed, must be raised from 3% to something closer to what the interest rates are on government bonds (e.g. 7% or 8%). Thus, the long debate on co-operatives

is likely to continue.

PROVINCIAL CORPORATION INCOME TAXES (See Table 3)

Between the years 1945 and 1952 all provinces imposed their own corporation taxes, and no federal abatements were allowed for these taxes. This meant that prior to 1952 the total tax rate payable was the sum of the federal rate and the provincial rate in question: thus, in Ontario in 1947, the straight-line federal rate was 30% and the provincial rate was 7% so that the total rate payable was 37% -- this remained unchanged until the end of 1951; in Quebec, for the period 1947-51, the provincial rate was also 7%; for all other provinces, the rate was 5%. In 1952, all provincial corporation income taxes were eliminated, except in Quebec where the rate remained at 7%; a 5% abatement was allowed in 1952 and the full 7% was allowed for the period 1953-6. In 1957 Quebec increased its rate to 9% and Ontario adopted a rate of 11%, an abatement of 9% being allowed in both provinces. In 1960, Quebec increased its rate to 10%, and to 12% in 1961 -- an extra 1% abatement was allowed in Quebec only in lieu of university grants. The return of taxing powers to all provinces became effective for 1962 and subsequent years; the 9% (10% in Quebec) abatement was unchanged, and the provincial rates adopted were 9% in Alberta, Prince Edward Island, Nova Scotia, New Brunswick, British Columbia and Newfoundland, 10% in Manitoba and Saskatchewan, 11% in Ontario, and 12% in Quebec. These rates were not changed until 1967 when the abatement was increased to 10% for all provinces; the rate in Quebec has remained unchanged and is still 12% today; in Ontario the rate was raised to 12%, and this has also remained unchanged to the present; the rates in Newfoundland have been 11% in 1967, 12% from April, 1968,

and 13% in 1969; in Manitoba and Saskatchewan, the rate rose to 11% in 1967 and has since remained unchanged in Saskatchewan but rose to 13% as from September, 1969 in Manitoba; in Alberta the rate rose to 10% in 1967, and to 11% as from July, 1969; in all other provinces (including British Columbia), except the Yukon and the North-West Territories, the rate rose to 10% in 1967 and has since remained unchanged.

OTHER PROVINCIAL TAXES ON CORPORATIONS

The most important other provincial taxes have been imposed on the mining and logging industries. These can be described summarily by province as follows:-

Ontario:

Mining Operations income tax

Year	Rate	Income Level
1954-6:	6%	$10,000 - 1,000,000
	8%	$1,000,000 - 5,000,000
	9%	Over $5,000,000.
1957-68:	6%	$10,000 - 1,000,000
	11%	$1,000,000 - 5,000,000
	12%	Over $5,000,000.
1969:	15%	All income in excess of $50,000.

Logging Tax

1954-62	9%	All income in excess of $10,000.
1963-69	10%	All income in excess of $10,000.

****

Quebec: Mining Operations income tax

Year	Rate	Income Level
1954-66	4%	$10,000 - 1,000,000
	5%	$1,000,000 - 2,000,000
	6%	$2,000,000 - 3,000,000
	7%	Over $3,000,000.
1967-69	9%	$50,000 - 1,000,000
	11%	$1,000,000 - 2,000,000
	13%	$2,000,000 - 4,000,000
	15%	Over $4,000,000.

Logging Tax

1963-69	10%	Over $10,000.

****

British Columbia: Mining Operations income tax

Year	Rate	Income Level
1954-68	10%	Over $25,000.
1968	15%	Over $10,000.

Logging Tax

1954-68	10%	Over $25,000.
1968	15%	Over $10,000.

****

Newfoundland: Mining Operations income tax

Year	Rate	Income Level
1949-69	5%	Taxable income. (20% for iron mines).

****

Manitoba:

Mining Operations income tax

Year	Rate	Income Level
1949-69	8%	Over $10,000.

****

Saskatchewan:

Mining Operations income tax

Year	Rate	Income Level
1947-59	3%	$10,000 - 100,000
	5%	$100,000 - 200,000
	7%	$500,000 - 1,000,000
	12½%	Over $1,000,000.

[These rates apply only to quartz mining, and all mines starting after Jan. 1, 1947. Others pay 12½%.]

1960-9	12½%	flat rate.

****

Alberta: Unspecified flat rate tax per acre on minerals (oil leases) from 1956.

****

New Brunswick:

Mining Operations income tax

Year	Rate	Income Level
1949-67	7%	$10,000 - 5,000,000
	9%	Over $5,000,000.
1967	7%	$10,000 - 1,000,000
	8%	$1,000,000 - 5,000,000
	9%	Over $5,000,000.

****

Nova Scotia:

1956-69 - 33-1/3% tax on gypsum mining earning over $5,000.

****

North-West Territories: Mining Operations Tax

Year	Rate	Income Level
1960-9	3%	$10,000 - 1,000,000
	5%	$1,000,000 - 5,000,000
	6%	$5,000,000 - 10,000,000
	For profits over $10 million add 1% for each $5 million.	

****

Yukon: Mining Operations Tax

Year	Rate	Income Level
1968 -	As for N. W. T.	

****

Note that all mining and logging taxes paid to the provinces are deductible from the federal corporation tax.

TAX ALLOWANCES FOR DEPRECIATION

Changes in the tax allowance for depreciation may be made temporarily or permanently. The former, short-term counter-cyclical changes, are usually intended to stabilize investment by altering the timing of investment projects; the latter, long-term acceleration of depreciation, may be intended to increase the volume of investment over time.

In 1949, the diminishing balance method was introduced into

Canadian Law. This method is based on historical or original cost. Each year a fixed percentage is allowed for depreciation, but this is not a percentage of the original cost, but of what remains of the original cost after the depreciation of previous years has been deducted. The rates used under this sytem, therefore, are higher than under a straight-line system because of the diminishing base to which the rates are applied. This accounts for the fact that the rates used after 1949 were roughly double those used before that date. Prior to 1949 Canadian tax law specifically disallowed the deduction of capital costs from income, and then made exceptions to the general rule by providing for such depreciation and depletion deductions as the Minister in his discretion might allow. Under this system there were many objections to the principle of ministerial discretion, and no allowance whatever was provided for obsolescence.

The new system uses various "declining balance depreciating rates" to determine the maximum depreciation expense allowed to be set against income for the purposes of calculating the amount of corporation tax payable; its intention is to provide for the amortization of all depreciable assets. The system applies to twelve classes of assets, and the maximum depreciation rates range from 4% in Class 1 to 100% in Class 12. The maximum depreciation rates of the four most important classes in Canada are given as follows:-

Class 2.	Oil and gas pipelines; electric generating equipment.	6%
Class 3.	Buildings (excluding frame buildings which are 10%).	5%

Class 8.	Machinery and equipment; furniture and fixtures.	20%
Class 10.	Motor vehicles; mining and logging; oil and gas well equipment.	30%

The problem of obsolescence is dealt with under this post-war system because the taxpayer is now guaranteed the recovery of the capital cost of an asset. Since most assets are depreciated heavily during the early years of their use, the problem of obsolescence is dealt with.

The most important depreciation policies used in Canada since 1949 have been short-term counter-cyclical measures. There have been two types: first, deferments of depreciation (1951, 1966 and 1969); and secondly, temporary accelerations of depreciation (1961 and 1963). Such measures involved changing the maximum depreciation rates; temporary changes clearly only affect the timing, rather than the total amount, of taxes paid. The present-value of a depreciation acceleration or deferment is dependent upon the discount rates used by the companies in evaluating their investment projects. Table 4[1] shows a present value comparison of the various depreciation policies employed in Canada since 1949, and a brief description of each of these policies now follows.

1951 Deferment: The 1951 budget included a provision that certain classes of capital expenditures (including Class 8) were no longer to be eligible for any depreciation allowance for four years. By late 1951 some exemptions were granted (following an easing of inflationary pressure),

---

1. Table 6.1 from J. F. Helliwell, "Public Policies and Private Investment", 1968, pp. 126-7. Photocopied.

and by the end of 1952 regular depreciation allowances were available on all assets. The present values in Table 4 are calculated on the assumption that those businessmen making expenditure decisions in 1951 incorrectly believed that the deferment would last for four years.

1966 Deferment: In the 1966 budget certain classes of assets purchased between March 29, 1966 and October 1, 1967 would receive restricted depreciation allowances for three years after their acquisition: the rates applicable to Classes 3 and 8 were reduced by one-half, and the 30% rate on Class 10 asset was reduced to 20%. Again, in Table 4, the present values are calculated on the assumption that the decision-makers believed that the measure would last for three years, and also that the deferment would apply to all expenditures made before October 1, 1967. In fact, it was removed for all assets purchased after March 31, 1967.

1969 Deferment: The June 1969 budget recommended that depreciation be deferred on commercial buildings erected up to the end of 1970 in major urban centres (at least 50,000 population) in Ontario, Alberta, and British Columbia. It is intended that these deferred payments will direct resources "to institutional building and housing, developments ... having difficulty obtaining funds, and to new plants and equipment".

1961 Acceleration: From January 1st, 1961 to January 1st, 1964 depreciation was allowed at double the usual rate for all depreciable assets in the year of purchase, with the normal rates applicable in all subsequent years. From June 21, 1961 to April 1, 1964 a further 50% increase of depreciation in the year of purchase was allowed. These measures were intended to encourage re-equipment and modernization, but, as Table 4

shows, the present-value impact of the measures was considerably smaller than that of either the 1951 or 1966 deferment, and the result of a Taxation Commission mail questionnaire also indicated that the measures had little influence on investment expenditure.

1963 Acceleration: The 1963 budget proposed that Class 8 assets purchased by corporations with 25% beneficial Canadian ownership (and a proportionate number of Canadian directors) should receive 50% straight-line depreciation for the two years commencing June 14, 1963. On July 8, 1963, the class of firms eligible was broadened to include any firm whose shares were listed for sale on a Canadian stock exchange, as long as not more than 75% of the shares were owned by a single foreign shareholder and his associates. The April 1965 budget extended the deadline to the end of 1966. The March 1966 budget reaffirmed the December 1966 expiry date, and, at the same time, announced the 1966 depreciation deferment to apply to all assets purchased after March, 1966.

The 1963 budget also proposed that new manufacturing and processing businesses in designated areas of slow growth should be allowed 50% straight-line depreciation on Class 8 assets and 20% straight-line depreciation on Class 3 assets.

TABLE 1

FEDERAL CORPORATION INCOME TAX RATES 1945-70

Year	General Rates (including the Old Age Security Tax)	
1945-6	18%	
1947-8	30%	
1949	10%	on first $10,000
	33%	on excess
1950	15%	on forst $10,000
	38%	on excess
1951	15%	on first $10,000
	46.6%	on excess
1952	22%	on first $10,000
	52%	on excess
1953-4	20%	on first $20,000
	49%	on excess
1955-7	20%	on first $20,000
	47%	on excess
1958	20%	on first $25,000
	47%	on excess
1959-60	21%	on first $25,000
	50%	on excess
1961	21%	on first $35,000
	50%	on excess
1962-6	21%	on first $35,000
	50%	on excess
	5%	refundable tax on "cash profits"
1967	21%	on first $35,000
	50%	on excess
1968-70	21.54%	on first $35,000
	51.41%	on excess.

TABLE 2

Corporation Income Tax and Profits Tax Declared
by Taxable Companies Reporting a Profit
For Selected Years 1945-67

$ million

Tax Years	Number of Companies	Current Year Taxable Income	Net Taxable Income	Total Income Tax Declared	Excess Profits Tax Declared	Ontario Quebec and Foreign Credits	Profits after Total Taxes and Credits
1945	21,331	1,199	1,196	213	461		525
1947	27,272	1,777	1,765	485	167		1,125
1948	27,997	1,946	1,932	568	20		1,358
1949	28,570	1,865	1,848	572			1,293
1950	31,239	2,359	2,334	760			1,599
1951	33,720	2,795	2,757	1,164			1,631
1952	35,228	2,654	2,618	1,239			1,415
1953	37,545	2,666	2,626	1,161			1,505
1954	39,152	2,423	2,378	1,021			1,402
1955	44,774	2,943	2,869	1,193			1,750
1956	52,517	3,316	3,223	1,330			1,986
1957	55,023	3,166	3,098	1,147			2,019
1958	59,251	3,098	2,996	1,071			2,027
1959	67,413	3,566	3,467	1,314			2,252
1960	68,579	3,493	3,383	1,290			2,203
1961	72,290	3,624	3,505	1,323			2,301
1962	78,241	3,943	3,749	1,383		250[a]	2,310
1963	87,310	4,252	4,017	1,469		270	2,513
1964	94,821	4,634	4,386	1,638		298	2,698
1965	78,406	4,921	4,622	1,687		309	2,925
1966	87,944	5,155	4,874	1,749		327	3,079
1967	93,562	5,332	5,017	1,810		353	3,169

a estimated.

TABLE 3

PROVINCIAL AND COMBINED CORPORATION TAX RATES 1947-70

Year	Abatement		Provincial and Combined Upper Rates					
			Q.	O.	Nfld.	Man. & Sask.	Alta.	Other[c]
1947-8	0	Prov.	7	7	a	5	5	5
		Comb.	37	37		35	35	35
1949-51	0	Prov.	7	7	5	5	5	5
		Comb.	40	40	38	38	38	38
1952	5	Prov.	7	0	0	0	0	0
		Comb.	54	52	52	52	52	52
1953-4	7	Prov.	7	0	0	0	0	0
		Comb.	49	49	49	49	49	49
1955-6	7		7	0	0	0	0	0
			47	47	47	47	47	47
1957-8	9		9	11	0	0	0	0
			47	49	47	47	47	47
1959-60	9[b]		9-10	11	0	0	0	0
			50	52	50	50	50	50
1961	9[b]		12	11	0	0	0	0
			52	52	50	50	50	50
1962-6	9[b]		12	11	9	10	9	9
			52	52	50	51	50	50
1967	10		12	12	11	11	10	10
			52	52	51	51	50	50
1968	10		12	12	12	11	10	10
			53.41	53.41	54.41	52.41	51.41	51.41
1969	10		12	12	13	11	11	10
			53.41	53.41	54.41	52.41	51.41	51.41

Notes: a Newfoundland not in confederation prior to 1949.

b Additional 1% in Quebec in lieu of University grants.

c Except Yukon and N.W. Territories.

TABLE 4

TAX ALLOWANCES FOR DEPRECIATION

(TABLE 6.1: Helliwell, J.F.)

Change in depreciation provision	Present value of the acceleration (+) or deferment (-), expressed as a percentage of the initial cost of the depreciable assets. A 50% corporation income-tax rate is assumed in all the examples		
	If the target rate of return used for discounting is:		
	(a) 5%	(b) 10%	(c) 15%
Effect on Class 8 assets of the 1951 deferment, had the measure been anticipated by firms to be carried out as originally announced. Depreciation rate of 20% on the declining balance deferred for four years and then started on the same basis	-7.1%	-10.6%	-12.2%
Effect of 1966 deferment on Class 3 assets. Depreciation rate of 5% on the declining balance deferred for 3 years and then started again on the same basis	-3.4%	-4.1%	-4.3%
Effect of 1966 deferment on Class 8 assets. Depreciation rate of 20% on the declining balance deferred for 3 years and then started again on the same basis	-5.5%	-8.3%	-9.8%
Effect of 1966 measure on Class 8 assets which were eligible for the 1963 acceleration. Depreciation rate 50% straight line changed to 25% straight line	-4.3%	-6.3%	-7.1%
Depreciation rate of 5% on the declining balance doubled to 10%	+8.3%	+8.3%	+7.5%
Effect of Regulation 1108, 1961, on Class 3 assets, including most buildings. (See Section A(2)(a) for details.) Depreciation rate of 5% raised to 10% for the first year only, thereafter reverting to 5% on the declining balance	+1.2%	+1.5%	+1.6%
Effect of Regulation 1109, 1961, on Class 3 assets. (See Section A(2)(a) for details.) Depreciation rate of 5% raised to 7½% for the first year only, thereafter reverting to 5% on the declining balance	+0.6%	+0.7%	+0.8%

TABLE 4

A. CHANGES IN DEPRECIATION RULES

(TABLE 6.1 -- continued)

Change in depreciation provision	Present value of the acceleration (+) or deferment (-), expressed as a percentage of the initial cost of the depreciable assets. A 50% corporation income-tax rate is assumed in all the examples		
	If the target rate of return used for discounting is:		
	(a) 5%	(b) 10%	(c) 15%
Effect on Class 3 assets of 1963 measures providing accelerated depreciation for new manufacturing or processing businesses in areas of slower growth. (See Section A (2)(b) for details.)			
Depreciation rate of 5% on the declining balance changed to 20% straight line	+18.3%	+21.3%	+21.0%
Depreciation rate of 20% on the declining balance raised to 40%	+4.4%	+6.7%	+7.8%
Effect of Regulation 1108, 1961, on Class 8 assets, including most machinery and equipment. (See Section A(2)(a) for details.)			
Depreciation rate of 20% on the declining balance raised to 40% for the first year, and 20% on the declining balance thereafter	+1.9%	+3.0%	+3.7%
Effect of Regulation 1109, 1961, on Class 8 assets. (See Section A (2)(a) for details.)			
Depreciation rate of 20% on the declining balance changed to 30% for the first year and 20% on the declining balance thereafter	+1.0%	+1.5%	+1.9%
Effect of 1963 measures to provide accelerated depreciation for all Class 8 assets purchased by corporations with the necessary degree of Canadian ownership and control. (See Section A (2)(b) for details.)			
Depreciation rate of 20% on the declining balance changed to 50% straight line	+6.5%	+10.1%	+12.0%
Depreciation rate of 20% on the declining balance raised to 100%	+7.6%	+12.1%	+14.9%

Source: HELLIWELL, J.F., "Public Policies and Private Investment", pp. 126-7.

BIBLIOGRAPHY

1. Asper, I. H., The Benson Iceberg.

2. Brittain, J. A., "The Tax Structure and Corporate Dividend Policy", A.E.R., 1964.

3. Brown, E. C., "Tax Credits as Investment Incentive", National Tax Journal, Vol. 15, 1962.

4. Canadian Tax Foundation, The National Finances, 1950-70.
   The Burden of Canadian Taxation, (I. J. Goffman) 1962.
   The Financing of the Canadian Federation, (A. M. Moore) 1966.

5. Dominion Bureau of Statistics, Catalogue 68-201 (Annual), "Principal Taxes and Rates", 1952-69.

6. Farano, R. J., The Income Tax Act Annotated, 1964.

7. Finnis, F. H., "Provincial and Municipal Taxation in Canada": Canadian Tax Foundation. "Oil and Gas Production and Taxes", (Canadian Tax Paper 33) 1963.

8. Gilmour, "Income Tax Handbook", 1968, Vols. I and II.

9. Goode, R., "Special Tax Measures to Restrain Investment", I.M.F. Staff Papers 5, 1957.

10. Helliwell, J. F., Public Policies and Private Investment, 1968.

11. Helliwell, J. F., "Taxation and Investment - A Study of Capital Expenditure Decisions in Large Corporations", Studies of the Royal Commission on Taxation, No. 3, 1964.

12. Levesque, R., "Commentary", C.J.E., Feb. 1970.

13. Perry, J. H., Taxes, Tariffs and Subsidies, Vol. 12, 1955.

14. Perry, J. H., Taxation in Canada, 1951.

15. Petrie, J. R., The Taxation of Corporate Taxation in Canada, 1952.

16. Petrie, J. R., Fiscal Policy and the Development of the Canadian Tax System.

17. Report of the Royal Commission on Taxation, Vol. 4. Taxation of Income flowing through Intermediaries. Determination of Business Income. 1966.

18. Spencer, B., "The Shifting of the Corporate Income Tax in Canada", C.J.E., Feb. 1969.

19. Spencer, B., "Reply". C.J.E., Feb. 1970.

20. Van Hoom, J. Jr., "Tax Treatment of Research and Development", Paris, OECD, 1962.

INTERNATIONAL ASPECTS OF INVESTMENT BEHAVIOUR

A Working Paper for:

THE INDIV PROJECT

under the direction of

J. C. R. Rowley

July, 1970

Philip Hardwick

This paper is a survey of the many topics included under the heading "foreign investment". The title is so general that a detailed study is impossible.

There are a number of different types of foreign capital movements, the main division being between the investment of one developed country in another, and the investment of a developed country in an underdeveloped country. Investment may be public or private, the latter being induced principally by the independent desire of businessmen to earn profits. It may be long-term or short-term, "autonomous" or "accommodating", and it may have many forms: Loans or grants to foreign governments or companies, gifts, the establishment of subsidiary firms on foreign soil, the building of public utilities abroad, the purchase of the shares of foreign companies - all these represent different types of foreign investment.

International aspects of investment behaviour can be distinguished in some important ways from domestic investment. Three very strict assumptions would be necessary for foreign and domestic investment to be indistinguishable; these are, first, that the capitalist sphere should be a single united economy with completely free movement of labour and free opportunities for entrepreneurs; secondly, that the capital market should be unified so that investment could be made without reference to their national origin; and, finally, that there should be complete laissez-faire. Under these conditions, interest rates, profits and wages would be equalized

throughout the capitalist world (this would not apply to investment in underdeveloped countries). In reality, however, these conditions are by no means fulfilled; labour tends to be immobile between countries (though there may still be a broad tendency towards factor price equalization through the setting up of ideas of what is fair or through the free movement of traded products[1]). Language barriers, national preferences and active governments are all imperfections which enable us to distinguish between home and foreign investment. Many theoretical analyses of foreign investment behaviour allow wages to vary internationally, but keep profit and interest rates uniform, by assuming that labour is immobile between nations, that governments are inactive internationally, that entrepreneurs are free to make investments where they please, that buyers and sellers have no national prejudices, and that capital markets are completely unified. More realistic results can be obtained by relaxing the second and last of these, and allowing for active governments, and separated capital markets.

This paper is divided into four sections. Section I considers capital movements between developed countries: The effect of foreign investment on the balance-of-payments, the distinction between "autonomous" and "accommodating" movements, purchasing-power transfers and the German reparations problem, and an interesting theoretical approach to foreign investment, are all topics included in this section. Section II considers

---

1. See Samuelson, P.A. International Trade and the Equalization of Factor Prices. Economic Journal, 1948.

the determinants of foreign, particularly U.S., ownership and control in Canada, and briefly examines the performance of the foreign-controlled firms. In Section III, the reasons for, and effects and problems of capital formation in underdeveloped countries are considered. Finally, Section IV examines modern investment generally and compares modern opportunities with those enjoyed by British entrepreneurs at the end of the 19th Century and in the early part of the 20th Century.

I.

International Investment Between Developed Countries

A country's balance of payments is a summary statement of all economic transactions between the residents of that country and the rest of the world over a particular period of time. Such a statement must include all types of international investment - public and private, direct and portfolio, "autonomous" and "accommodating". In the schematic balance of payments for Country X (Page 4), the make-up of the capital account and its relationship with the current account, unilateral transfers account and the 'below-the-line' balancing account can be examined. The balances on current account (Items 1-5) and unilateral transfers (Items 6-7) are frequently added together; this balance of items 1-7, adjusted to exclude goods in prior income periods, constitutes a measure of net foreign investment.

Country X's long-term foreign investments are recorded as item 8. These consist mainly of direct investments in tangible physical assets of business firms abroad, and of portfolio investment in securities of various

Schematic Balance of Payments for Country X.

		Payment (Debit -)	Receipts (Credit +)
A.	Current Account		
1.	Merchandise	-	+
2.	Transportation	-	+
3.	Tourist Expenditures	-	+
4.	Investment Income; fees and royalties; other services	-	+
5.	Military and other government expenditures	-	+
	Total 1 - 5	-	+
B.	Unilateral Transfers		
6.	Private remittances	-	+
7.	Government transfers	-	+
	Total 1 - 7	-	+
C.	Capital Account[1]		
8.	Long-term foreign investment: (direct and portfolio)	-	+
9.	Short-term capital movements: Country X, private	-	+
10.	Short-term capital movements: Foreign, Private	-	+
	Total 1 - 10	-	+
D.	Balancing Account[1]		
11.	Short-term official capital movements	-	+
12.	Gold Movements	-	+
	Total 1 - 12	-	+

1. Increase in assets or reduction in liabilities (-).

Note: Items 1 - 10 "Above the line". Items 11 - 12 "Below the line".

kinds. Items 9 and 10 represent private short-term capital movements which include changes in foreign or domestic currency working balances intended to facilitate the financing of regular commercial transaction or to take advantage of international differences in interest rates. There is some controversy, however, as to whether private short-term capital movements should be recorded, in whole or in part, "below the line" in item 11 rather than "above the line" in items 9 and 10. The argument for recording these movements in item 11 is that they may be largely transitory in nature, and will therefore be reversed within a short time, and, further, that they cannot be readily distinguished from official short-term capital transactions.

The transactions recorded on page 4 may be interpreted according to whether they are "autonomous" or "accommodating". Autonomous transactions may be assumed to have been undertaken in response to commercial incentives on political considerations that are given independently of the state of the overall balance of payments or of particular accounts - the "above the line" items 1-10 may thus be regarded as autonomous. Accommodating movements, on the other hand, arise out of the government's decision to fill the gap between total autonomous receipts and payments - thus, the transactions in items 11 and 12 may be regarded as accommodating. Such transactions have been described as "stopgap financing"[1], and include such measures as drawing down bank accounts abroad, selling gold, receiving loans from abroad, and accepting gifts from abroad.

---

1. Yeager, L.B. International Monetary Relations.

Long-term capital movements (which are independently motivated, and, therefore, autonomous) typically reflect investors own judgments about where they can lend their funds at high interest rates, or invest it for high dividends or profits. An inflow of long-term capital tends to raise a country's capital formation, and hence, its productive capacity and attainable level of consumption. The country's ability to provide for the transfer of interest and profits on the capital, and for the eventual repayment of the capital sum are also increased. Such an inflow is inevitably accompanied by a deficit in the country's current account - this is the only way the capital can enter the country in real terms as the counterpart of the financial transfer. "To welcome an inflow of long-term investment capital while deploring a current - account deficit is to fight sheer arithmetic."[1]

The distinction between autonomous and accommodating transactions defines a country's balance-of-payments deficit. An overall deficit (surplus) is an excess of long-term debit (credit) over long-term credit (debit) capital transactions. A typical overall deficit involves a current account deficit not fully covered by long-term capital inflows, and the remainder being financed by accommodating movements. A typical surplus involves a current account surplus not fully matched by long-term capital outflows, and the remainder being matched by such accommodating transactions as loans or gifts to foreign countries. Unfortunately, it is very difficult in practice to know where to draw the line between autonomous and accommodating movement, and so the distinction between the two is vague. Even current account transactions are affected by government policies, and could, therefore, to some extent, be regarded as accommodating. It is possible to arrange the balance

---

1. Yeager, L.B., op. cit. p. 46.

of-payments account in a variety of ways for purposes of analysis. But since all arrangements hinge on imputing scientific motivations of an autonomous or accommodating nature to particular classes of transactions, they are bound to involve some degree of arbitrariness.

Consider, for the moment, autonomous capital movements. These have been traditionally used as the theoretical example of balance-of-payments disturbances. There are three possible reasons, not directly connected with trade, why investors of one country may wish to invest funds in another: First, there may be higher interest rates or profit prospects; secondly, there may be a change in taxation which favours the investment; and thirdly, there may be a rise in savings of which a part seeks placements abroad. Such capital movements will create a disequilibrium in a country initially in balance. To restore equilibrium in the capital-exporting country, current account imports must be reduced, or exports increased. Clearly, if the proceeds of the investment are to be used in the lending country (as in the case of a tied loan) the question is trivial, but if not, then more resources will be made available in the borrowing country and fewer in the lending country. Holdings of domestic money initially go down in the lending country and up in the borrowing country. The banks and other dealers will initially increase their assets in lending-country currency, and reduce them in borrowing-country currency; <u>if</u> the banks and other dealers accept these changes without trying to reverse them in the wholesale foreign exchange market, they will make possible a transfer of cash balances from lenders to borrowers. This purchasing-power transfer will tend to adjust

trade, but is likely to be incomplete for two reasons: First, borrowers and lenders are not likely to reduce and increase their respective total spending by the full amount of the loan; and secondly, changes in total spending will probably impinge only fractionally on purchases abroad rather than at home. It is possible, however, that the banks and other dealers will not accept the above changes, and if speculators will also not accept them, then gold will flow, or the foreign reserves of the lending country's exchange-pegging authority will be drawn down. In this case, repercussions on money supplies, prices and incomes will promote the adjustment of trade.

Some of the problems of making large transfers from one country to another were brought out in the discussions of the German payment of reparations after the First World War. This payment was an unrequited inter-governmental transfer, and led to the famous Keynes-Ohlin controversy of the 1920's.[1] Keynes made the distinction between budgetary and transfer problems, the former being that of levying taxes or otherwise raising the necessary amounts of home money, and the latter being that of achieving the German export surplus necessary to provide the required foreign exchange. He focused attention on the price changes disadvantageous to Germany which would be needed to produce a large enough export surplus, and he assigned only a minor role to the purchasing power transfer. He wrote:

> "Only those who believe that the foreign demand for German exports is very elastic, so that a trifling reduction in German prices will do what is required, are justified in holding that the Transfer Problem is of no great significance apart from the Budgetary Problem."[2]

---

1. See Keynes and Ohlin's articles in the Economic Journal, March and June, 1929. Also see Metzler, L.A., "The Transfer Problem Reconsidered" J.P.E., June, 1942.

2. Keynes, J.M., Economic Journal, March 1929.

Ohlin was more optimistic. He claimed that the Germans, having surrendered purchasing power to pay reparations would be less able to afford imports, while the foreign recipients would be more able to buy German exports. Of course, only a fraction of the cutbacks in spending made by German taxpayers and of the additional spending done by the foreign beneficiaries would impinge directly on internationally traded goods. But the changes in spending on domestic goods would tend to produce contraction in Germany and expansion elsewhere, causing labour and capital, and domestic market production abroad. Ohlin thus maintained that important aspects of the adjustment mechanism would operate even if German prices did not decline at all relative to prices in the countries receiving reparations. Yeager suggests that more emphasis should be placed on government budgeting.[1] He claims that if the governments of the two countries wanted to accomplish a 'real' transfer between them, the paying government should raise the necessary sum by increasing taxes or by cutting its own expenditure or both, and the other government should use the payments received to reduce taxes or expand its own expenditures or both.

Finally in this section, an interesting theoretical approach to foreign investment is examined. Macdougall[2] set out this approach, which is, in the main, static, with reference to private investment from abroad in Australia, but it applies equally well to Canada or any other of the developed nations. The analysis attempts to assess the difference made to the real income of Australia at a given moment by the presence of more

1. Yeager, L.B. op. cit., p.

2. Macdougall, G.D.A. "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach", Economic Record 1960.

or less foreign-owned private capital in the long-run. Initially, it is based on the following assumptions (which are numbered for ease of reference later).

(i) The government maintains a constant degree of employment of Australian resources.

(ii) No taxation.

(iii) The size of the labour force is independent of the stock of foreign capital.

(iv) The stock of Australian-owned capital is independent of the stock of foreign capital.

(v) No external economies.

(vi) Constant returns to scale.

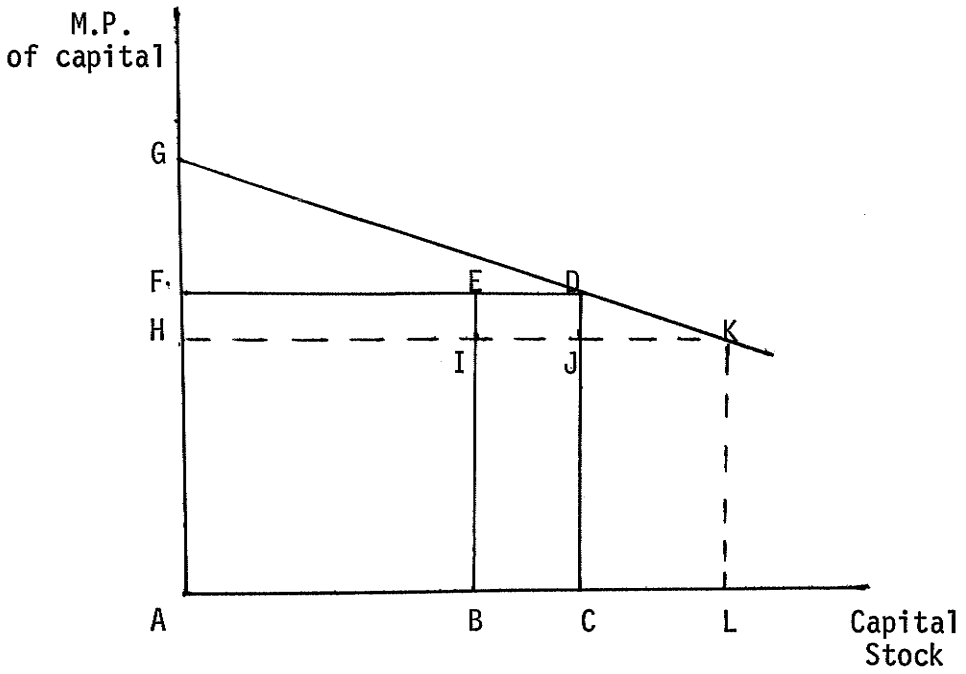
(vii) Perfect competition.

(viii) Foreign investment has no effect on the terms of trade.

(iv) Foreign investment creates no difficulties for the balance of payments.

(v) It does not require changes in government policy which may in themselves involve a loss to Australia.

Now consider the following diagram which relates the marginal product of capital with the capital stock. The line GK represents this relation, given the amount of labour. The initial capital stock is AC (AB is owned by Australians, and BC by foreigners); total profits are FEBA on home capital, and EDCB on foreign capital. Output is GDCA, and labour receives GDF. Let foreign capital increase from BC to BL; foreign profits become IKLB. The new capital earns JKLC and the old foreign capital loses EDJI because the


M.P.
of capital
G
F
E
D
H
K
I
J
A
B
C
L
Capital
Stock

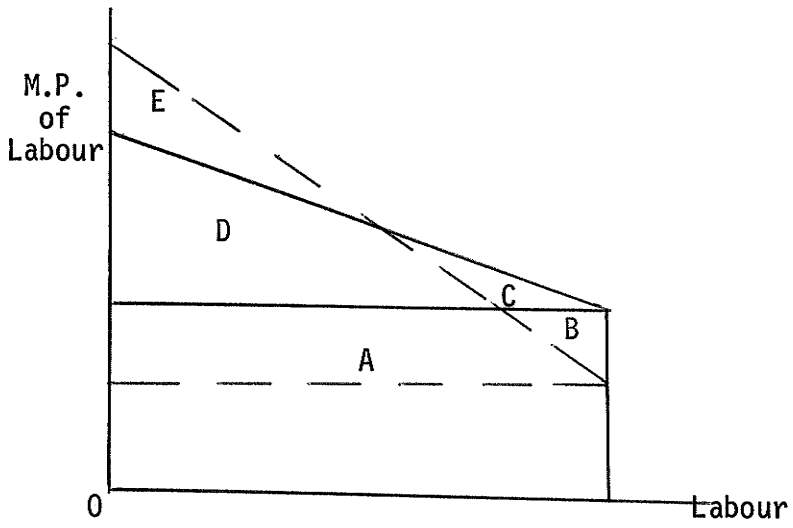
marginal product of capital (and hence the profit rate) has fallen. Australian capitalists lose FEIH, and labour gains FDKH. Australia as a whole gains EDKI (which is approximately equal to EDJI).

Elaborating upon this model, Macdougall now sets about removing each of his assumptions in turn. First, he relaxes assumption (ii) and allows for taxation; if the rate of tax on foreign profits is t, Australia will gain t(JKLC) + (1 - t)(EDJI) which is a gain over the situation without taxation. Secondly, assumption (iii) is relaxed, so that the size of the labour force is not completely independent of the stock of foreign capital; if the labour force were to increase at the same rate as the total capital stock, there would be an exactly similar increase in total output[1], total profits and total wages; the wage and profit rates would be restored to their initial levels, and, assuming no taxation, the average Australian worker, instead of being better off, would have exactly the same income as before. The relaxation of assumption (iv) would be likely to increase Australian income even further; the higher the stock of foreign-owned capital is at some future date, the higher it must be at most intervening dates; thus, Australian income is likely to be higher in these intervening years which may suggest that Australian saving and investment will be higher; this would mean that at the future date the stock of Australian-owned capital would have increased with the stock of foreign-owned capital (this is a very uncertain sort of relationship).

---

1. Because we have assumed constant returns to scale.

Next, Macdougall relaxes assumption (v) and allows for possible external economies from the extra foreign investment. If the value added to output by this capital exceeds the profit, before tax, earned on it, the difference will be the value of such external economies - these would probably bring a further gain to Australia: consider the following diagram:



The external economies shift the marginal product of labour curve from the full to the dotted line. Output increases by E - C- B (positive). The wage bill is down by A + B, and profits increase by E + A - C. Australia could only lose from external economies if labour's loss was nearly as large as capital's gain. The removal of

assumption (vi) allows for economies of scale (these are distinct from external economies): it seems likely that economies of scale would bring a further gain to Australia when foreign capital is increased. Endless examples are possible when assumption (vii) is relaxed and imperfect competition is allowed for - Macdougall concludes that this theoretical analysis is not very satisfactory for imperfect competition. Macdougall does not consider the relaxation of assumption (viii) as being very important: he claims that it is difficult to predict the overall effect of an increase in foreign investment on the terms of trade, but any change is likely to be small because some government policy (particularly the one of trade barriers) will be used to correct deficits or surpluses on the balance of payments. Finally, Macdougall removes assumptions (ix) and (x). He claims that the effects on the balance of payments are likely to be more important than the effects on the terms of trade; the effects may be favourable, but the danger of future balance-of-payments crises may be increased because there are inevitably fluctuations in the net inflow of private capital, and part at least of the foreigners' profits have to be transferred across the exchanges. Two examples of the removal of assumption (x) are as follows: first, the government may provide more information about investment opportunities in Australia, and the cost of this would have to be debited before striking a balance. Secondly, higher protection, designed to encourage investment

in Australia by foreign producers who are prevented from exporting direct, may mean sacrificing some of the benefits of the international division of labour.

The above theoretical approach is clearly limited in its usefulness. The initial model with its ten rigid assumptions is far removed from reality, and as the assumptions are relaxed, too many uncertainties arise. We will consider briefly the possible benefits of foreign investment to the investing country in section IV. For now, Macdougall's theoretical study of foreign investment in Australia leads us directly to the next section, and a look at foreign ownership and control of industries in Canada.

II.

Foreign Investment in Canada

Business enterprises in a particular country are usually owned and controlled by residents of that country because entrepreneurs tend to be internationally immobile. Domestic businessmen know the laws and customs of their own country, and have established contacts there maintained by friendship and nationalistic feelings. A scarcity of capital in one country relative to another, and, therefore, a higher yield on real assets, attracts capital from abroad, but there is no reason why this should increase foreign ownership and control of domestic industry. Resident entrepreneurs could

borrow capital from abroad to set up new enterprises, or foreigners could buy outstanding or new issues of stock - in the latter case foreign ownership would rise, but in most instances, the firms would remain under the control of domestic entrepreneurs. The existence of wholly-owned subsidiaries of foreign firms, and the outright purchase of established domestic firms by foreigners is the phenomenon which requires explanation in the case of Canada.

A little of the investment in Canada since the Second World War has been financed domestically by borrowing from abroad, a little has taken the shape of purchases of some of the stocks of Canadian-owned firms by foreigners, but most has been direct investment in subsidiaries by foreign firms (chiefly U.S.) and the purchase by foreigners of all the stocks of existing firms, previously Canadian-owned. This situation suggests that foreign entrepreneurs are at no net disadvantage compared with Canadian entrepreneurs in those industries in which foreign control is particularly prevalent. Foreign ownership and control is not simply a response to the relatively high yield on capital in Canada, but is based on the characteristics of the firms and industries in which foreign control is important.

This hypothesis is developed by Eastman and Stykolt[1] on the basis of the distinction between economies of firm scale and economies

---

1. Eastman, H.C. and Stykolt, S.: The Tariff and Competition in Canada, Ch. 4.

of plant scale. In some industries, the long-run average cost curve declines as output increases beyond that of a single plant of the most efficient size - this may be for one or more of three reasons: first, economies of scale in research and development; secondly, differentiation of product through advertising and sales technique; and thirdly, advantages in obtaining capital because of real economies in borrowing. In these cases, multiplant operations may be expected to be set up. Any such factors as foreign tariffs or the Canadian tariff which decrease the size of the markets in which plants compete will increase their interdependence, decrease their size, and increase the incidence of multiplant operations.

Clearly, the existence of advantages of multiplant operations does not in itself explain the high proportion of foreign control in Canada. Where the advantages arise exclusively from domestic factors, such as market control in Canada, the firms are most likely to be owned by Canadians. But where the advantages arise from factors that are not specific to Canada, some multiplant firms may be based abroad. In other words, the causes of economies of multiplant operations will either favour national ownership, or will be neutral - but they will not favour foreign ownership directly. What advantages do foreign firms have over Canadian ones, of which the evidence is a preponderance of foreign control and ownership? There are two possible advantages.

First, Great Britain, the U.S.A., and Europe all experienced

industrial development earlier than Canada. According to Eastman and Stykolt, this may have created a relatively high level of knowledge abroad which provided a superior position for the competition of foreign firms in Canada. However, to be effective, this early lead would have to be enforced by such devices as patents or superior access to raw materials, and these were not significant in the industries examined by Eastman and Stykolt. There seems little reason why early entrance into an industry should provide firms with a permanent advantage.

The second, more plausible, advantage is that U.S. firms tend to be larger than Canadian ones. This is not significant for the average size of all firms, but the firms abroad with which Canadian companies become linked by affiliation or outright ownership are largest in the U.S.A., and these are typically much larger than the biggest Canadian firms. It is known that foreign firms controlling Canadian capacity are based on plants which are larger than Canadian ones, and which are established in more competitive markets. The size of plants is larger in the U.S.A. than Canada because the U.S.A. has larger markets and less interdependence of plants and, hence, less downward pressure on plant size. It may be that the larger foreign plants form a more dynamic base for a firm's expansion by the acquisition of other plants or by direct investment. Firms operating in large foreign markets are under greater pressure to minimize costs than in Canada

because their market is bigger and the interdependence of firms is less. This may lead to emphasis on technological progress and economies of scale. It may be the factor giving foreign firms an advantage over Canadian firms which permits them to expand into Canada. The U.S. and Canadian tariffs have two effects which are relevant here: first, they induce and permit the establishment of productive units of inefficiently small capacity in Canada; and secondly, they contribute to low productivity and low incomes in Canada. It may be argued, therefore, that the tariffs contribute towards the promotion of foreign ownership of Canadian manufacturing industries.

The larger plants abroad (particularly in the U.S.A.) enjoy three main economies of firm scale. These contribute to the economies of multiplant operations, and, therefore, play their part in promoting foreign ownership of Canadian industry. They are as follows: First, economies in selling: it is impossible to tell statistically the extent to which these are responsible for foreign ownership because of imprecise data, and because product differentiation is closely related to economies of multiplant operations because of research and development. Secondly, economies in research: large firms are able to marshall, use and produce knowledge more efficiently. Finally, economies in financing: this is true because large firms are able to borrow funds at a lower cost per unit than small firms,[1] because

1. This is because larger firms are more well-known, and also because they can borrow large amounts and some borrowing costs are fixed.

large sums are available to big firms which are able to save out of profits, and because large firms can risk considerable sums on projects with uncertain success (though this is of slight importance in manufacturing industries).

This section is concluded with a note about performance. The most important observation about the performance of the subsidiaries of foreign companies in Canada is that it is so varied. Only certain generalisations can be made here, and for a more detailed analysis see the studies of A.E. Safarian.[1] Most of the subsidiaries in Canada produce close to the full range of the parent's products, while their size is only about 5 - 10 per cent of that of the parent. Their unit costs are typically higher, which is partly due to the Canadian tariff and foreign trade barriers. Comparing the larger foreign-owned firms in Canada with resident-owned counterparts shows that economic performance is more related to other variables than country of origin, and that they do not appear to differ significantly in terms of either exports or research. The foreign-owned firm does tend to import more than its resident-owned counterpart, but not markedly so. The foreign-owned firm in Canada is generally less efficient than its parent, e.g. its unit cost of production is typically higher, and its research and development expenditures are a smaller proportion of sales and involve much less fundamental research.

---

1. Safarian, A.E. Foreign Ownership of Canadian Industry (1966). Safarian, A.E. The Performance of Foreign-Owned Firms in Canada (1969).

III.

Foreign Investment in Underdeveloped Countries

An underdeveloped country may be classified as one of the following three types: first, those more or less empty lands which have been settled by emigrants who trade with the developed nations; secondly, those inhabited by peoples of a simple level of culture; and thirdly, those inhabited by highly complex ancient civilisations which somehow failed to develop the capitalist "rules of the game", and in which the majority of people are peasants dominated by a small class of wealthy landowners. Usually, the products which the capitalist sector is interested in acquiring are not forthcoming from these underdeveloped economies in large enough quantities, and it thus becomes necessary for capitalist entrepreneurs to set about organizing their production. Capital and labour are exported from the capitalist sector, and are financed and organized in exactly the same way as domestic investment, though located overseas. However, some local labour has to be employed, and during the period of development, the outlay on this local labour exceeds the value of the product, so that foreign investment is being made in an economic, as well as geographical, sense. Increased wages increase expenditures (there is likely to be little saving), and this increases imports until they equal the value of the investment. That part of the investment which is not matched by a movement of capital goods to the territory being

developed is matched by a surplus of exports from the capitalist sector. Such an investment may well be an influence against threatening stagnation in a developed country. Once the period of development is over, the export of the goods to the developed country will be balanced partly by payments out of profits as interest and dividends to investors in the developed country; partly by retained profits; partly by remittances from managers' salaries; and partly by exports to local populations whose incomes have increased. Finally, local entrepreneurs may set up their own businesses and local savings may become available for lending; eventually, as the economy becomes more and more capitalist itself, there may be a move to expropriate the foreigners.

The problems faced by underdeveloped countries in the field of investment were analyzed in some detail by R. Nurkse.[1] The first problem is the well-known, so-called "vicious circle of poverty" which works to keep poor countries poor. It works in two ways. First, on the supply side, there is a small capacity to save resulting from the low level of income; this is a reflection of low productivity which is due largely to the lack of capital; the lack of capital is in its turn a result of the small capacity to save. Secondly, on the demand side, the inducement to invest may be low because of the low real incomes (and hence purchasing power); the low incomes are a result of

---

1. Nurkse, R. Problems of Capital Formation in Underdeveloped Countries (1953).

low productivity which in turn is a result of the small amount of capital used (which may, at least partly, be caused by the small inducement to invest). Nurkse points out that although one might expect the demand for capital to be great in underdeveloped countries, the inducement to invest is limited by the size of the market, and the lack of domestic purchasing power in real terms.

Two other problems faced by underdeveloped countries are overpopulation and underpopulation. Characteristic of overpopulated nations is a large degree of what Nurkse calls "disguised unemployment", in the sense that a large part of the population engaged in agricultural activities could be removed without reducing agricultural output - and this could be achieved with no improvement in technical methods. In other words, the marginal product of labour is zero, or even negative. The problem faced here is to take the surplus people from the land and set them to work on capital projects - the question is how to finance this. There are two possible sources of finance: first, an inflow of capital from abroad; and secondly, domestic savings. Nurkse points out that the state of disguised unemployment implies a disguised saving potential as well. Productive labourers perform "virtual" saving in the sense that they produce more than they consume, but this is offset by the unproductive consumption of those labourers who contribute nothing to output. If the productive labourers were to send the unproductive ones to work on capital projects, then their

virtual saving would become effective saving. In this way, Nurkse argues that the use of disguised unemployment for the accumulation of capital can be financed from within the system itself.

Similarly, in underpopulated nations, the problem is to transfer people from unproductive to productive occupations. In this case, this may be accomplished through technical improvements in agriculture so that manpower can be released and set to work on capital projects. To finance this, savings must be increased; clearly, they could be increased, provided that consumption remained at the original level.

So far we have examined some of the ways in which underdeveloped countries might raise their real incomes, and thereby be able to finance some measure of capital formation. However,we still face the problem of the self-perpetuating tendency for capital to be in short supply in low-income areas. In theory, foreign investment in the underdeveloped country may bring about the initial improvement in productivity and real income that is required for any substantial domestic saving to come about. Prebisch,[1] for one, maintains that foreign investment breaks the "vicious circle" on the supply side - once an increase in productivity has been achieved, a flow of saving will result, or can be extracted, from the increased real income. Nurkse is dubious of this theory; he claims that underdeveloped countries will still be worse off compared with the richer

1. Prebisch, R. The Economic Development of Latin America and its Principal Problems. United Nations, 1950.

nations even if their real income rises - he believes that in poor countries there is an increasing awareness of the higher living standards of other countries.

Finally, the two main sources of foreign capital in underdeveloped countries require examination. The first is direct business investment, and the second is foreign loans and grants. Direct business investment is subject to private profit motives, and one of the problems is that a very large proportion of foreign capital has gone into extractive industries working mainly for export to the developed countries. This has not been a result of planning, but a result of the free play of private profit motives - foreign capital in underdeveloped nations found it profitable to work for the big markets in the industrial countries since purchasing power was miserably low in the domestic markets. This situation is not to be despised - it increases the country's export and import capacity, and it contributes to the growth of various external economies, such as labour skills and public works. The usefulness of such economies will vary considerably depending on the technical features of particular projects or industries.

Foreign loans and grants are the second source of external capital. They can be used for domestic economic development in accordance with some overall plan, and past experience suggests that they

can lay the foundations of a country's economic development in the form of public services and social overhead capital. The main disadvantage of a foreign loan is that the funds may be substituted for domestic savings so that the country's consumption is increased, and little or no addition is made to the rate of capital accumulation - this can clearly happen whether or not the loan is tied to a particular project. The transfer of funds from rich to poor may be desirable in welfare terms, but it does not solve the problem of capital formation in underdeveloped areas. Finally, the backwardness and lack of overhead capital in such countries create a limit to their absorptive capacity; also, capital formation involves a movement of people and goods which takes time, and restricts the rate at which foreign aid can be effectively used for purposes of investment.

There are clearly many problems where capital formation in underdeveloped countries is concerned. Perhaps the greatest good that developed countries can do is to revive the public-utility type of foreign investment which would make conditions more attractive for more varied and smaller-scale business investments. Many people believe that the industrial nations have a moral obligation to invest in underdeveloped areas. General G.C. Marshall[1] claimed that it is "of basic importance to any successful effort towards an enduring peace that the more favoured nations should lend assistance in bettering the lot of the poorer."[2]

---

1. General Marshall gave his name to the Marshall Plan.
2. The Times, 12th December, 1953.

IV.

Foreign Investment Today in the Light of Nineteenth Century Experience

Public opinion has almost always been against foreign investment. The French experience prior to the First World War illustrates that this bias may not be unjustified. By 1914 France had invested about £500 million in Russian bonds bearing 4% and 5%. Russia, however, was spending half of the money on armaments, and had been more or less on the verge of bankruptcy since the 1890's; not a penny of the £500 million was recovered. France also lost large sums by imprudent lending to Turkey, Greece, Austria-Hungary, the Balkans, and South America. The main reason for these French losses was lack of information on the part of the individual investors.

For Britain, however, there is a good case for believing that investment in other countries in the 19th Century was economically advantageous to both the investors and the nation as a whole. There were some defaults, but, in general, the return in profits and interest, was substantial. The building of railways, the provision of banking and insurance facilities, the financing of public utilities of all kinds, the operation of mining ventures, and so on, provided the country with advantages over and above the expectations of prudent investment. Unfortunately, uncertainty about the composition of the British portfolio makes it difficult to give any accurate estimate of the profit gained

on each type of investment. Overall, however, it is estimated[1] that British capitalists earned some £4000 million in just over forty years in interest and dividends on their foreign investments. This represented an average income from abroad of £100 million per year (the National Dividend was £900 million in 1870, and £2300 million in 1913). Although the figure of £4000 million is quite accurate it is not possible to say how much more home investment would have been undertaken if foreign investment had been less popular. Britain made three major gains from investing so much abroad in the period 1870 - 1913: First, the expansion of purchasing power in foreign markets boosted British exports and led to gains from certain economies of scale in the export industries. Secondly, there was a spread of information of profitable investment opportunities, and the credit-worthiness of borrowers became better known. Finally, fresh sources of supply of much-needed foodstuffs were opened up.

The question now arises why cannot twentieth century America recreate the nineteenth century environment in which Britain gained so much from foreign flows of capital. Nurkse[2] claims that the nineteenth century circumstances were in a number of ways quite exceptional. Over the fifty years preceding the First World War, Great Britain's foreign investments amounted to 4% of her national income, and this

---

1. See Cairncross, A.K. Home and Foreign Investment 1870-1913.

2. Nurkse, R. "International Investment Today in the Light of Nineteenth Century Experience", Economic Journal, Vo. 64 (1954).

ratio was 7% in the period 1905 - 13. For the U.S.A. to do the same today would involve capital exports of up to $20 billion (U.S.) per year. Nurkse suggests a number of reasons why Britain's rate of foreign investment was unique.

First, two-thirds of Britain's capital exports were to the newly-settled regions of the world, like Canada, the United States, Argentina and Australia, and these were where most gains were made. The achievements in the tropical or subtropical areas which were already inhabited by native populations, some with ancient civilisations, were more dubious. Today, there are no newly settled regions, and thus, opportunities for highly profitable investments are not so favourable.

Secondly, the bulk of the British investments were not in colonial ventures: 30% was in loans to governments, 40% in railway securities, 5% in other public utilities, and the remainder was in banking, public utilities, and the remainder was in banking, insurance, manufactures, and raw material extraction. The people in the newly-settled countries were, in the main, from Europe themselves, and therefore knew what to do with the capital and how to handle it. Over a half of Britain's external investments before 1914 were in railways, again principally in the newly-settled countries. The markets were created in these countries by labour, enterprise and capital all drawn from Europe. In industrially primitive countries, markets were and have remained unattractive because of mass poverty.

Finally, one of the chief obstacles to U.S. investment in underdeveloped countries has been the high level of business profits obtainable at home. Although this situation could change, it seems unlikely that direct investment alone can become anything like an adequate source of international finance for economic development. This type of foreign investment played only a minor role in the nineteenth century, and it is very doubtful that it will have been of any greater importance in the second half of the twentieth century.

This paper has dealt briefly with a number of topics in the field of international investment. It is a hotch-potch of trivia, but it presents a background to the subject, and this may be useful and of some interest.

Bibliography

1. Cairncross, A.K. Home and Foreign Investment 1870-1913 Studies in Capital Accumulation. Cambridge, 1953.

2. Eastman, H.C. and Stykolt, S. The Tariff and Competition in Canada. Macmillian, 1967.

3. Gilbert, A.G. International Investment. Simmons-Boardman. 1963.

4. Keynes, J. M. "The German Transfer Problem"; Economic Journal, 1929, p. 1. Also see pp. 179-82 and pp. 404-8.

5. Kindleberger, C.P. International Economics. R.D. Irwin, 1958.

6. Metzler, L.A. "The Transfer Problem Reconsidered"; J.P.E., June 1942.

7. Nurkse, R. Problems of Capital Formation in Underdeveloped Countries, Oxford University Press, 1953.

8. Nurkse, R. "International Investment Today in the Light of Nineteenth Century Experience"; Economic Journal, vol. 64, 1954.

9. Ohlin, B. "The Reparations Problem: A Discussion..." Economic Journal, 1929, p. 172. Also see pp. 400-403.

10. Prebisch, R. The Economic Development of Latin America and Its Principal Problems, United Nations, 1950.

11. Robinson, J. The Accumulation of Capital. Macmillan, 1965.

12. Safarian, A.E. The Performance of Foreign-owned Firms in Canada. Canadian-American Committee, 1969.

13. Safarian, A.E. Foreign Ownership of Canadian Industry. Toronto: McGraw-Hill, 1966.

14. Samuelson, P.A. "International Trade and the Equalisation of Factor Prices"; Economic Journal, June, 1948.

15. Stern, R.M. The Balance of Payments: Theory and Economic Policy. (unpublished).

16. Yeager, L.B. International Monetary Relations: Theory, History and Policy. Harper and Row, 1966.

THE ECONOMICS OF LEASING

A Working Paper for:

THE INDIV PROJECT

under the direction of
J. C. R. Rowley

August, 1970

Philip Hardwick

Where the acquisition of industrial equipment is concerned a business firm is faced with three possibilities: to lease, to buy, or to borrow. Leasing, which is the renting of capital, has emerged in recent years as a major source of corporate funds. Unfortunately, there are no available statistics which allow us to compare leasing with the more traditional forms of acquiring capital, but in some industries it is undoubtedly the main method of acquisition employed. Clearly, the rise of leasing in recent years has done much to confuse the capital budgeting procedures of business firms: one theory claimed that if a firm had more investment opportunities than it had available capital, it should continue to seek new outside capital until it reached the point where the cost of obtaining new capital was greater than the return which could be expected from investing that capital; the problem that there was no agreed upon way of measuring the cost of capital was overcome by assuming that a decision-maker would select those investments which would best utilize his available funds -- in accomplishing this, the actual cost of the funds did not need to be measured since it was assumed to be lower than the profit which could have been made by investing the funds. Straightforward theories of this kind are complicated by the introduction of leasing.

There are many factors which need to be considered in making leasing decisions. Advocates of leasing have proposed a long list of advantages over the last twenty years, and opponents have proposed a long list of disadvantages.[1] Some of the most important ones may be briefly mentioned

---

1. See R. F. Vancil, Leasing of Industrial Equipment. McGraw-Hill, New York, 1963, pp. 6-7.